

Testimony of
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Committee on Financial Services
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On
H.R. 3763, the Corporate and Auditing Accountability,
Responsibility, and Transparency Act of 2002

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I. Introduction

Chairman Oxley, Congressman LaFalce, members of the committee, thank you for this opportunity to testify on behalf of the National Association of Manufacturers (NAM), which represents 14,000 members (including 10,000 small and mid-sized companies) and 350 member associations serving manufacturers and employees in every industrial sector and all 50 states.

Let me begin by saying that the issues we are discussing today are both numerous and complex, including accounting standards, financial reporting, corporate governance, the proper role of outside auditors, retirement plans and other issues. First and foremost, I am here to say that the overwhelming majority of corporations and private firms are characterized by high standards of accounting, financial reporting and management – all grounded on the values of honesty and integrity. Additionally, changes in these areas should be made first in the private sector before public policy changes are initiated. While we certainly don't assert that no public policy changes may be necessary, it is important that we move carefully, fully analyze all the facts, and put things into accurate perspective. Particularly in light of pending criminal charges, it is critical that we pay close attention to due process and not rush to judgment.

II. Importance of Honest and Complete Information

On behalf of our broad membership, I want to emphasize that we believe the success of our economic system is predicated on certain fundamentals, the most critical being the availability of complete, accurate, timely and transparent information on the companies that comprise our private market system. Prompt and reliable information is essential to enable capital markets to efficiently allocate capital to uses that increase productivity and growth, for investors to determine if their capital is being properly employed, and for the broad public to be served.

Of course, it is one thing to state the necessity of complete and accurate information and another to both define it and do it. The accepted standard for determining whether information is complete and accurate is the Generally Accepted Accounting Principles (GAAP), in conjunction with SEC regulations. The purpose of GAAP, as you know, is to state fairly and completely the financial condition of a company, presenting revenues and expenditures, assets and debts, in the proper time period. This is essential to accurately calculate earnings, cash flow and other measures of performance. Timely, accurate and complete reporting of sound measures of performance is critical for ensuring that investors and employees have the information necessary to assess the success and viability of businesses for the present and the future.

The NAM believes that the responsibility for providing complete and accurate information to investors and the public rests first with management, attested to by independent auditors, supported by a knowledgeable and informed audit committee, working under the attentive scrutiny of the company's board of directors. Public policy has the broad responsibility to provide appropriate traffic rules, incentives and penalties.

III. Reinforcement of Best Practices

Accordingly, each of these parties needs to adhere to best practices for financial and corporate governance. There is an elaborate body of best practices guidelines available that need continuous emphasis and improved application.

Management

Management is the first line of defense in ensuring that the highest standards of integrity are observed in providing the full disclosure of financial and accounting information to auditors, the audit committee and the board. Management must exercise due diligence to obtain as full and complete a picture of the enterprise's operations as is possible, and to share relevant information with the auditors, audit committee, the board and, where appropriate, the public at large. Management's attitude and philosophy regarding the importance of maintaining the highest standards of integrity, particularly with regard to financial reporting, play an important role in ensuring that such standards are upheld at all levels throughout the organization.

Outside Auditors

Independent auditors must be truly independent in order to fulfill their responsibility of providing complete and accurate audits, including an assessment of the adequacy of internal controls. Management and the audit committee should encourage and require such independence, not compromise it. The audit committee should be composed of knowledgeable directors recommended by management and approved by the nominating committee. The committee should be empowered to take all necessary actions to assure audits are accurate and credible, including the setting of fees, the terms of the contract and review of any consulting agreements. It should also set clear rules about what additional services the auditing firm can provide to the company.

Also, it is clear that there needs to be sharper delineation between auditing and consulting. That is not to say that companies should not be able to legitimately use certain non-audit services of the auditing firm. In some cases, it may be in the company's and the public's best interest to capitalize on the firm's knowledge of the business, to save both time and money and to provide the most accurate information. However, auditors certainly cannot audit what they have created, i.e., a firm cannot design the accounting system if it is also going to audit the financial system. Finally, auditors should not be in the position of worrying about their firm's

consulting relationship with the client when making audit-related decisions. Nor should they feel pressure to negotiate down auditing fees based on how much the client spends on consulting. This is an obvious conflict of interest that should be avoided.

Audit Committee

The audit committee must be composed of members who are knowledgeable about corporate accounting and finance and experienced in corporate management. The committee must work closely with management and the outside auditors while maintaining appropriate independence in order to fully exercise its supervisory review function. The audit committee should also have the primary relationship with the outside auditor, ensuring that the auditor understands that his primary obligation and reporting responsibility are to the audit committee.

Board of Directors

The board of directors has the broad responsibility for assuring that the enterprise's management, outside auditors and audit committee are fulfilling their basic functions and preserving their independence in the quest for providing complete and accurate information about the enterprise's operational and financial status.

One good guide to these principles is the SEC's statement regarding the selection and disclosure by public companies of critical accounting policies and practices (12/13/2001), which stresses the judgment required by auditors in addition to mere adherence to GAAP. It also emphasizes the importance of Management's Discussion and Analysis (MD&A). This bulletin is a very good guidance document, stressing the appropriate ideals that should be the goal for all public and private companies. Had these principles been followed, a strong case can be made that the Enron problem could have been prevented. This again points out the importance of understandable, accurate and full disclosure of relevant investor information buttressed by careful judgment on the part of outside auditors and the audit committee.

While we believe that the overwhelming majority of firms in the NAM membership adhere to these high standards, best practices for financial and corporate governance need to be re-emphasized and, where appropriate, strengthened. All firms should strive to achieve world-class quality status not only in products and services, but also in the information they use to manage and represent their companies. Clearly, this improvement is the broad responsibility of the private sector.

IV. Possible Reforms to Consider

That said, in the current environment, it would be wise to review what public policy changes may be needed. I know that this committee will do this, and we welcome the opportunity to work with you.

For example, one idea that merits study is the Public Regulatory Organization (PRO) that H.R. 3763 would create. This PRO appears to have the authority and responsibility to take on preventative investigations of accounting firms before the damage is done. Such a PRO may be better suited to discipline accountants and accounting firms than the profession or the SEC presently can.

Another public policy change to consider is increasing the resources of the Financial Accounting Standards Board (FASB) and the SEC. Additional resources would help to improve the quality of public standards, education and prevention. Some of these resources could be used to simplify and improve the clarity of the current system.

Additionally, section 6 of H.R. 3763 seems to track many of the goals included in the SEC's statement regarding the selection and disclosure by public companies of critical accounting policies and practices (12/13/2001) referenced in section III above. It would ensure that both management and auditors exercise judgment about what key accounting principles are affecting the apparent financial position of a company and how.

In addition, the President has recently offered a ten-point plan to improve corporate responsibility for complete and accurate information. Overall it is a mixed bag, but it does include some very good ideas. In particular, I would note his first two points regarding investor access to information. First, the President correctly asserts that each investor should have quarterly access to information needed to judge a firm's financial performance, condition and risks. Secondly, he emphasizes prompt investor access to critical information. Timely access to accurate information and transparency are key to wise investment choices.

Some of the President's other proposals are less clear, both in their intent and in how they would be applied. For example, point four of the plan states that CEOs or other officers should not be allowed to profit from erroneous financial statements, and point five suggests that CEOs or other officers who abuse their power should lose their right to serve in any corporate leadership positions. While the objectives of these recommendations are appropriate, the definition and determination of wrongdoing are unclear.

Section 2 of H.R. 3763 also warrants additional exploration. This provision would restrict the ability of auditors to provide services, other than the audit, to audit clients. While there is certainly merit to avoiding conflicts of interest, an absolute prohibition against providing any internal audit service is impractical. For example, there may be times when it would be in the best interest of the company and investors to have the same firm that provides its external audits conduct an internal audit of a discreet process, either because the firm is particularly suited to follow up on questions raised in the audit, or because the firm knows and understands the company's business best. Therefore, the firm would be in the best position to detect weaknesses and provide best-practice recommendations to management. In any case, as long as a conflict of interest can be avoided, wholesale prohibition is unnecessary.

We are still in the process of looking at many of these and other proposals and gathering information on them. The NAM has not taken a position on any of the above measures but is committed to carefully considering and advocating measured reforms to improve the system and protect investors.

That said, there are several areas which currently work quite well and should be left alone. For example, the NAM is extremely concerned that hasty legislative action in response to the collapse of Enron will have a negative impact on our voluntary retirement system, widespread stock ownership among employees, and the 401(k) assets and retirement security of millions of employees. It is imperative that Congress and the Administration fully investigate the facts surrounding the Enron case before making any changes to current retirement policy or regulation. I have yet to see where mistakes at Enron merit wholesale changes to our 401(k) programs. Currently, 56 million American workers participate in 401(k), profit sharing and employee stock ownership plans (ESOPs). One of the hallmarks of the current system – flexibility for employers to design benefits packages that are most appropriate for their workers – is a crucial component of the system’s success. Percentage caps, limits on holding periods and diversification mandates will limit employee choice and deter employer matches. Imposing a one-size-fits-all approach by limiting certain investment choices – most notably company stock – will hurt many workers who strongly support their ability to make their own investment choices. We urge Congress to focus instead on encouraging investment education and professional investment advice so that workers have the tools they need to make wise retirement planning decisions.

Secondly, there should not be major changes to accounting for stock options. Stock option accounting in no way led to the Enron situation, and there is no basis for requiring changes to current practice. The current accounting rules for stock options provide a great deal of transparency and provide extensive, high-quality information to investors. Moreover, stock options provide employees with an ownership stake in the company and encourage increased productivity and innovation. They are a driving force behind economic growth. Major changes to the method of accounting for them would likely result in companies no longer providing broad-based stock option plans.

Finally, Congress is often tempted to create new legal liability in the face of a bad situation or bad actors. But the current rules are, in fact, working as intended to protect investors and the public. Securities fraud class action suits are alive and well. Settlement value of meritorious claims is up significantly, and auditors who engage in wrongdoing continue to face

substantial liability. Also, additional funding for the SEC, as mentioned above, would allow the enforcement division of the SEC to take full advantage of current law to prosecute more fully and quickly. The criminal charges pending against Andersen are further proof that current law provides more than adequate redress. It is not necessary to increase or create new legal liability.

V. Conclusion

In conclusion, we must maintain proper perspective on recent errors in company and accounting conduct. The vast majority of the more than 14,000 publicly-traded companies in the United States continually produce reliable financial statements. We have a good and dependable system that deserves the international respect it has had over the years.

Secondly, we must improve application of current standards. There are a lot of good ways to improve the system simply by diligently applying the rules of the current system. In fact, progress in transparency is already evident in the wake of recent SEC initiatives. We are seeing greater emphasis on GAAP rather than pro forma earnings, disclosure of key accounting policies, and more comprehensive liquidity discussions. Things are already moving in the right direction within the existing framework, and we should continue to reemphasize best practices for financial accounting and corporate governance.

If we apply and use best practices, little new legislation or regulation should be required. Any new laws should be limited so as not to do harm by adding undue cost, complexity or liability, while still protecting the investor.

The NAM looks forward to working with you as you sort through these thorny issues. We appreciate the opportunity to be here today and present our views. Thank you.